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Taxation--Federal Estate Tax--Inclusion in Gross Estate of Trust Property in Which Beneficial Life Interest or Possibility of Reversion Is Reserved in Settlor

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NOTE

TAXATION—FEDERAL ESTATE TAX—INCLUSION IN GROSS ESTATE OF TRUST PROPERTY IN WHICH BENEFICIAL LIFE INTEREST OR POSSIBILITY OF REVERSION IS RESERVED IN SETTLOR—The Supreme Court of the United States in *May v. Heiner*[1] interpreted the transfer intended provision of Sec. 401 (c) of the Revenue Act of 1918 to exclude from its scope the imposition of the estate tax upon an inter vivos gift wherein a life estate was reserved with final disposition to occur upon the death of the donor. The basis for this holding was that the gift had been complete when made and that by the death of the donor, no interest passed from her to the living. To prevent this method of tax avoidance, Congress on March 3, 1931, by joint resolution amended the similar provision of Sec. 302 (c) of the Revenue Act of 1926 to include, as taxable,

[1](1930) 281 U. S. 238, 50 S. Ct. 286, 74 L. Ed. 826, 67 A. L. R. 1244 and note, discussed in (1931) 15 MINNESOTA LAW REVIEW 252. The law on this subject prior to this case is thoroughly treated in Rottschaefer, Taxation of Transfers Intended to Take Effect in Possession or Enjoyment at Grantor's Death, (1930) 14 MINNESOTA LAW REVIEW 453, 613.

gifts wherein the donor retained a life estate. The amendment is substantially retained in the present act.[2] It was early decided that the 1931 amendment had no retroactive application to tax gifts effected or trusts created prior to its enactment.[3]

However, since the case of *Helvering v. Hallock,*[4] there has been some doubt as to whether *May v. Heiner* remains as good law. If it has been overruled, inter vivos gifts made prior to March 3, 1931, in which the donor retained a life interest, are taxable as transfers intended along with those now being taxed under Sec. 302 (c) of the Revenue Act of 1932 and subsequent re-enactments.[5] A second major problem raised by the *Hallock Case* is whether any gift or trust wherein the death of the donor eliminates even the remotest possibility of a reversion is taxable as part of the gross estate.

In the *Hallock Case,* a trust was created by A giving the income thereof to his wife B for life with a provision that if B should predecease A, the corpus was to revert to A. The court held that A's death cut off the possibility of reversion making the gift complete. This operative significance of A's death was held to bring the gift within the act as a "transfer . intended to take effect in possession or enjoyment at or after his death." In so finding the court specifically followed *Klein v. United States*[6] and rejected and overruled *Helvering v. St. Louis Trust Co.*[7] and *Becker v. St. Louis Trust Co.*[8] The question remained whether the holding of the case was broad enough to include in its scope

[2]U. S. C., tit. 26, sec. 811, 26 U. S. C. A., sec. 811, 6 F C. A., tit. 26, sec. 811. "The value of the gross estate of the decedent shall be determined by including the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated, except real property situated outside of the United States— (c) To the extent of any interest therein of which the decedent has at any time made a transfer, by trust or otherwise, in contemplation of or intended to take effect in possession or enjoyment at or after his death, or of which he has at any time made a transfer, by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death (1) the possession or enjoyment of, or the right to the income from, the property, or (2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom, except in case of a bona fide sale for an adequate and full consideration in money or money's worth. "

[3]Hassett v. Welch, (1938) 303 U. S. 303, 58 S. Ct. 559, 82 L. Ed. 858, discussed in (1938) 22 MINNESOTA LAW REVIEW 1066.

[4](1940) 309 U. S. 106, 60 S. Ct. 444, 84 L. Ed. 604, 125 A. L. R. 1368, discussed in (1940) 24 MINNESOTA LAW REVIEW 882.

[5]See footnote 2.

[6](1931) 283 U. S. 231, 51 S. Ct. 398, 75 L. Ed. 996.

[7](1935) 296 U S. 39, 56 S. Ct. 74, 80 L. Ed. 29, 100 A. L. R. 1239 and note, discussed in (1936) 20 MINNESOTA LAW REVIEW 570.

[8](1935) 296 U. S. 48, 56 S. Ct. 78, 80 L. Ed. 35.

the situation, as in *May v Heiner,* where the death of the donor merely cuts off the life estate he reserved in himself and makes the gift come into the actual enjoyment of the donee, or the situation where any interest, no matter how remote, reserved by the donor, is cut off by his death.

It appears that a strategic battle between the Commissioner of Internal Revenue and the courts has been waged on the question of the effect of the *Hallock Case* on *May v. Heiner* In *Commissioner of Internal Revenue v Hall's Estate,*[9] Circuit Judge Frank, dissenting, says, "In *Helvering v. Proctor,*[10] the government urged us to hold that *Helvering v. Hallock* had overruled *May v Heiner* A majority of our court refused to so hold, I dissented. For unexplained reasons, the government, having described *Proctor* to us as a test case, failed to seek certiorari. Its strategy seems to have been, instead, to make flank attacks designed to wear down *May v. Heiner* That strategy seems to have been successful."[11]

The Supreme Court has not yet had the problem, as such. In two cases in 1945, the court had before it the situation where the income was reserved to the grantor for life, however, another factor was found in each to allow the court to hold the gift taxable as a transfer intended without specifically overruling *May v Heiner* The first of these was *Fidelity Co. v Rothensies*[12] where the income for life from a trust was reserved to the settlor and given to her daughters upon her death. Upon the death of the daughters, the corpus was to go to their descendants, but if both daughters died without leaving surviving descendants, the corpus was to be paid to such persons as the settlor might appoint by will. The court held that this last "string" held by the settlor made the entire corpus taxable as a transfer intended. The next case was *Commissioner v Estate of Field*[13] in which a trust was created for the joint lives of two nieces and for the life of the survivor with the income to be paid to the settlor for his life and to named beneficiaries upon his death. There was a provision to the effect that if the trust terminated before the settlor's death, the corpus was to revert to him. It was held that this possibility made the gift a transfer intended since the settlor's death severed the possibility that the trust property might not go as directed in the trust

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[9](C.C.A. 2d Cir. 1946) 153 F (2d) 172.

[10](C.C.A. 2d Cir. 1944) 140 F (2d) 87, 155 A. L. R. 845 and note.

[11]153 F (2d) 172, 174.

[12](1945) 324 U. S. 108, 65 S. Ct. 508, 89 L. Ed. 782, 159 A. L. R. 227

[13](1945) 324 U S. 113, 65 S. Ct. 511, 89 L. Ed. 786, 159 A. L. R. 230 and note.

instrument. In both of these cases, Mr. Justice Douglas wrote concurring opinions pointing out that it was not necessary then to decide whether *May v. Heiner* survived the *Hallock Case.*

When the Circuit Courts of Appeals have had the precise problem, they have held that *May v. Heiner* is still good law.[14] But in a vigorous dissent in *Helvering v. Proctor,*[15] Circuit Judge Frank strenuously argued not only that *May v. Heiner* was overruled by the *Hallock Case,* but also that it was wrongly decided in the first place.[16] It would seem that the underlying principle of the *Hallock Case* and subsequent Supreme Court cases require the conclusion that *May v. Heiner* has been overruled. Since "Testamentary dispositions of an inter vivos nature cannot escape the force of this section by hiding behind legal niceties contained in devices and forms created by conveyancers,"[17] surely the reservation of the income for life in a gift makes the transfer of the corpus or income to the donee after the donor's death as much an actual gift at death as any of those heretofore considered.[18]

Three Supreme Court cases which have shed further light on the problem raised by the *Hallock Case* of the effect of the reservation of an interest by the grantor are *Fidelity Co. v. Rothensies*[19] and *Commissioner v. Estate of Field,*[20] discussed above, and *Goldstone v. United States.*[21] In the *Goldstone Case* concurrent life in-

[14]Commissioner of Internal Revenue v. Kellogg, (C.C.A. 3d Cir. 1941) 119 F (2d) 54, United States v. Brown, (C.C.A. 9th Cir. 1943) 134 F (2d) 372; Helvering v. Proctor, (C.C.A. 2d Cir. 1944) 140 F (2d) 87, 155 A. L. R. 845 and note; Commissioner of Internal Revenue v. Irving Trust Co., (C.C.A. 2d Cir. 1945) 147 F (2d) 946; Commissioner of Internal Revenue v. Hall's Estate, (C.C.A. 2d Cir. 1946) 153 F (2d) 172. Drummond v. Clauson, (D. Maine 1946) 67 F Supp. 872, is a recent district court decision holding to the same effect. But cf. Commissioner of Internal Revenue v. Bank of California (C.C.A. 9th Cir. 1946) 155 F (2d) 1 and Commissioner of Internal Revenue v. Bayne's Estate, (C.C.A. 2d Cir. 1946) 155 F (2d) 475, which on facts similar to May v. Heiner reach a contrary result on a different theory.

[15](C.C.A. 2d Cir. 1944) 140 F. (2d) 87, 89, 155 A. L. R. 845.

[16]Circuit Judge Frank argued. "Virtually all commentators agree that May v. Heiner was wrongly decided because it ignored the plain wording of Sec. 302 (c). For a remainder following a life estate reserved to the donor had always, before the enactment of Sec. 302 (c) been regarded as one which takes 'effect in possession or enjoyment at or after his death.' The words 'possession or enjoyment' were words of art with a well settled meaning, and their use in Sec. 302 (c) clearly showed that Congress meant that the time of passing or vesting of title should be of no consequence."

[17]Goldstone v. United States, (1945) 325 U. S. 687, 691, 65 S. Ct. 1323, 86 L. Ed. 1871, 159 A. L. R. 1330 and note.

[18]See Note, (1945) 40 Ill. L. Rev. 285, 289; Note (1940) Yale L. J. 1118, 1123, Paul, Federal Estate and Gift Taxation (1946 Supp.) Sec. 7.15.

[19]See footnote 12.

[20]See footnote 13.

[21](1945) 325 U. S. 687, 65 S. Ct. 1323, 89 L. Ed. 1871, 159 A. L. R. 1330. cf. United States v. Tonkin, (C.C.A. 3d Cir. 1945) 150 F (2d) 531, cert. denied (1945) 326 U. S. 771, 66 S. Ct. 176, 90 L. Ed. 106.

surance and annuity contracts were obtained by the insured.[22] By their terms the insured received the annuity income for his life, with his wife or daughters to receive proceeds from the insurance contract and the annuity contract upon his death, if they outlived him. While the insured lived, his wife had the unrestricted right to assign, borrow money, receive dividends, change beneficiaries, or even surrender the policies and obtain their cash surrender value. Nevertheless, the provisions that the insured was to get these rights if his wife predeceased him and that the proceeds were to go to his estate if he outlived both his wife and daughters were held to make the arrangement taxable as a transfer intended. The court said, "The essential element in this case, therefore, is the decedent's possession of a reversionary interest at the time of his death, delaying until then the determination of the ultimate possession or enjoyment of the property "

The Circuit Courts have applied the *Hallock Case* and the above subsequent cases in varying fact situations. In *Mulliken v Magruder*,[23] a partnership agreement provided that the decedent held a life interest in a 3/8 share of the partnership, with remainder to his son, but that upon termination of the partnership, 3/8 of the assets were to be distributed to the decedent. The court, on the basis that the death of the decedent cut off this last possibility and gave complete dominion to the vested remainder in the assets to the son, included the 3/8 interest in the gross estate as the subject of a transfer intended. In *Eldredge v Rothensies*[24] there was a trust reserving the income to the settlor for life with the remainder to her children or their issue, and if there be no children or issue living at the death of the settlor, as the settlor might by will appoint. The court held that the settlor's death cut off the "string" of this contingent power of appointment and therefore the gift was includible as a transfer intended. In *Dominick's Estate v Commissioner of Internal Revenue*[25] the same rule was applied to a trust whereby the income was to be paid to the son until he was twenty-five, at which time the corpus was to be turned over to him, but if the son died before he reached the age

[22]The court held that these two contracts must be considered together and contained none of the true elements of insurance risk. Therefore the section of the act relating to amounts receivable as insurance under policies taken out by the defendant was inapplicable, and the only question involved is whether the proceeds of the contract were the subject of a transfer intended.

[23](C.C.A. 4th Cir. 1945) 149 F (2d) 593.

[24](C.C.A. 3d Cir. 1945) 150 F (2d) 23, cert. denied (1945) 326 U. S. 772, 66 S. Ct. 336, 90 L. Ed. 222.

[25](C.C.A. 2d Cir. 1946) 152 F (2d) 843.

of twenty-five, the gift was to go to the settlor if still alive. The death of the settlor cut off this last possibility, making the gift taxable as a transfer intended. In *Central Hanover Bank & Trust Co. v. United States,*[26] the Court of Claims had under consideration a trust whereby the settlor reserved a life interest with remainder to her three children. At the trial it had been assumed that the applicable New York law would have effected a reversion to the settlor if she outlived all of her children, and the gift was found to be a transfer intended on the basis that she was chargeable with intending to reserve that possibility.[27] On motion for a new trial the estate prevailed on the basis that the New York law did not create such a reversion, or at least that it was in doubt, and hence the settlor might have thought it did not and therefore she had not intended to retain the possibility of reverter. The rule was stretched further in *Commissioner of Internal Rev. v. Bank of California*[28] where the settlor reserved the income to herself for life and provided that on her death the corpus was to be divided between her son and daughter or their issue. There was also a provision that if either of the beneficiaries predeceased the settlor without issue, the other beneficiary was to take his share. The Tax Court held that there was no possibility of the estate reverting to the settlor by the trust itself, and that such a reversion could only occur upon the settlor's surviving all of her two children and five grandchildren and then by operation of law, and that this possibility was not enough to render the corpus subject to the estate tax as a transfer intended upon the settlor's death. The Circuit Court reversed, quoting from *Fidelity Co. v. Rothensies*[29] and *Commissioner v. Estate of Field,*[30] to hold that this possibility of reversion created by law was enough to make the gift a transfer intended and that the cutting off of this possibility, no matter how remote it was, made the settlor's death the taxable event to include the entire corpus in her gross estate.[31] Relying on

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[26](Ct. of Claims 1945) 58 F Supp. 565.

[27]Central Hanover Bank & Trust Co. v. United States, (Ct. of Claims 1944) 57 F Supp. 497

[28](C.C.A. 9th Cir. 1946) 155 F (2d) 1, cert. denied (1946) 67 S. Ct. 73.

[29]See footnote 12.

[30]See footnote 13.

[31]Cf. Gallois v. Commissioner of Internal Revenue (C.C.A. 9th Cir. 1945) 152 F (2d) 81, cert. denied (1946) 66 S. Ct. 898, 90 L. Ed. 764. The same court in this case found a gift taxable as a transfer intended by virtue of a reversion provision in the trust instrument. The court points out that the reversion provided by the trust instrument would have existed in any event because of California law. The language of the case is not clear as to whether the same result would have been reached without the express reversion by the settlor.

these two cases also, the same result was reached in *Commissioner of Internal Revenue v Bayne's Estate.*[32] Here the grantor reserved the income of the trust to himself for life and on his death to the then surviving children or issue of the grantor and in default thereof to the surviving brothers and sister of the grantor or issue. The court held that the grantor retained an interest which his death terminated and the trust corpus was therefore includible in the grantor's estate. The court quoted from the *Field Case* "It makes no difference how vested may be the remainder interests in the corpus or how remote or uncertain may be the decedent's reversionary interest."

Notwithstanding the extent to which the courts have gone to impose taxability in these situations, some cases have indicated that *Helvering v Hallock* does not require the taxing of all inter vivos trusts regardless of the circumstances under which the remainders are to take effect in possession or enjoyment. In *Commissioner of Internal Revenue v Kellogg,*[33] the court considers the argument that the corpus might revert to the settlor by operation of law if he should outlive his beneficiaries and rejects it saying that if such an argument were allowed, every inter vivos trust would be includible in the grantor's estate. In *Lloyd's Estate v Commissioner of Internal Revenue,*[34] the same court applies the Kellogg Case, indicating that it considers it a logical limitation on the scope of Sec. 302 (c) Further argument for this view is given in *Post v United States*[35] where the court had before it a trust instrument which provided for the termination of the trust on the death of the survivor of named beneficiaries and the payment of the principal to lawful issue then living of persons named, or failing such issue, then to the lawful issue then living of the trustor. The contention of the Commissioner was that if all the designated persons had predeceased the settlor, the trust corpus would have reverted to the settlor, and that the settlor's death cut off this interest. However the court distinguished *Helvering v Hallock* and the *Fidelity Co.* and *Field Cases* from the case before it on the basis of no express reservation of interest by the settlor in the case before it, and in holding against taxability of the trust corpus said "It was a purely

[32](C.C.A. 2d Cir. 1946) 155 F (2d) 475. Cf. Thomas v. Graham, (C.C.A. 5th Cir. 1946) 158 F (2d) 561, Beach v. Busey, (C.C.A. 6th Cir. 1946) 156 F (2d) 496.

[33](C.C.A. 3d Cir. 1941) 119 F (2d) 54.

[34](C.C.A. 3d Cir. 1944) 141 F (2d) 758.

[35](E.D. N.Y. 1945) 61 F Supp. 380. This case was decided prior to Commissioner of Internal Revenue v. Bayne's Estate, (C.C.A. 2d Cir. 1946) 155 F (2d) 475.

inter vivos gift. Viewed in the strictest light, it cannot be interpreted as a devious device to avoid an estate tax by parting with property during her life."

It would seem that there still is some doubt as to the extent to which inter vivos trusts with a possibility of reversion created by operation of law are to be included in the donor's gross estate for estate tax purposes. Theoretically, there would seem to be little distinction between such reversion and one expressly made by the grantor except possibly as such expression would go to the question of whether there was a transfer *intended*. The exact rule is yet to be set out by the Supreme Court.